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Spiegel Online International

November 24, 2010 Wednesday 1:16 PM GMT+1

SECTION: PORSCHE'S POKER

LENGTH: 2193 words

HEADLINE: Turning the Car Business into a Casino

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HIGHLIGHT:

German prosecutors are probing accusations that Porsche conducted dodgy share deals during a failed takeover bid for Volkswagen. Meanwhile, hedge funds are suing the sports car maker in the US. Porsche may have to pay billions in damages, and VW could also find itself pulled into the mess.; http://www.spiegel.de/international/germany/0,1518,730911,00.html

BODY:

There are times when former Porsche CEO Wendelin Wiedeking makes a deliberate attempt to seem nonchalant, such as when he is being driven to his former place of employment in Stuttgart's Zuffenhausen district, where the German carmaker is headquartered. But this time he isn't being driven there in a chauffeured Porsche Cayenne, but by an employee of the Stuttgart transport authority: On this particular day, Wiedeking is taking the metro to Zuffenhausen.

He has a lunch appointment at the "Christophorus" restaurant in the Porsche Museum, which is said to serve the best steaks in Stuttgart. It's yet another of those superlatives for which the former chief executive is supposedly responsible, like so many others relating to the German sports car maker: billions in profits and losses, as well as the near-mythical rise of the company -- and its no less spectacular fall.

As Porsche CEO, Wiedeking ate steaks in New York that were better than

anything he had tasted in Germany. The secret supposedly lies in special ovens that reach temperatures in excess of 700 degrees Celsius (about 1,300 degrees Fahrenheit), sealing the pores in the meat in seconds. To achieve the same quality, Wiedeking had ovens imported from the United States for the Porsche restaurant. And why shouldn't he still enjoy those steaks today, even after being ejected from the company?

In Germany, prosecutors in Stuttgart are investigating Wiedeking and Porsche's former chief financial officer, Holger Härter. Meanwhile, hedge funds are suing them in the United States. The two former executives are accused of manipulating share prices during the sports car maker's attempt to acquire automotive giant Volkswagen, a much larger company. But did the two men really act alone?

Future of Porsche and VW at Stake

When Wiedeking is confronted with the issue, his air of nonchalance quickly evaporates. His attorneys have told him not to talk about the case, he says. By remaining silent, he has no choice but to accept the fact that he and former CFO Härter are publicly viewed as two sinister figures who, acting completely on their own, were supposedly out to capture Europe's biggest carmaker, throwing Porsche, VW and the entire market into turmoil in the process.

But the longer the investigations last, the clearer it becomes that the two former senior executives aren't the only ones who could face legal action. Nothing less is at stake than the economic security of Porsche, which could end up paying billions in damages. In fact, even the future of the Wolfsburg-based VW Group is at stake.

If Porsche is ordered to pay damages and is unable to raise the necessary cash, the company will have to sell its shares in VW. Porsche owns 50.7 percent of VW common stock, with a current market value of €16 billion ($21.6 billion). If these VW shares are put up for sale, they could fall into the hands of corporate raiders or Chinese competitors.

That's why VW CEO Martin Winterkorn and works council chairman Bernd Osterloh, who once numbered among Wiedeking's bitterest adversaries, are hoping that the investigations against the former Porsche boss fizzle out. But that doesn't seem likely at the moment -- quite the opposite, in fact.

Huge Sums Involved

The Stuttgart public prosecutor's office has found indications that Porsche may have violated Germany's Securities Trading Act and manipulated the price of VW stock. Parties to the proceedings believe that chief prosecutor Hans Richter will bring charges against Wiedeking and Härter.

A verdict against the two former top executives would serve as the basis for claims for compensation against Porsche. Two conciliation proceedings, in which affected parties are trying to settle out of court with Porsche and VW, suggest how much money could be involved.

In the first case, Deka Investment Gesellschaft and two investment funds are demanding that Porsche SE pay €2.1 billion. In the second case, the law firm CLLB wants VW to pay its clients €2.4 billion.

There is also a case pending in a district court in New York, where 35 investment funds are seeking to recover more than $2 billion in losses from Porsche SE. Seven other funds have already joined the action. The judge intends to decide whether the suit is admissible on Jan. 17.

Shedding Light on Deals

Finally, German lawyer Mark Binz is demanding a special audit of Porsche on behalf of Deka Investment. Binz hopes the audit will shed light on Porsche's share transactions and the €71 million in severance payments that went to Wiedeking and Härter.

These are all just claims and allegations at the moment. There have been no trials or convictions yet. But VW takes the allegations so seriously that it has postponed the planned merger with Porsche. And Porsche, for its part, fears that shareholders will take advantage of the upcoming shareholders' meeting on Nov. 30 to settle accounts and reject a planned capital increase intended to raise fresh cash for the company.

There are plenty of reasons to be asking critical questions. The prosecutors' investigations and the statements made by the law firms involved show how Wiedeking and Härter transformed the small sports car company into a gigantic casino.

Within just a year, the company earned profits of more than €50 billion with stock option deals, while losing a similar amount with other stock transactions. By that time, the car business had already faded into the background.

Härter was Porsche's master of the universe. He is, in a sense, the opposite of Wiedeking, who can be boisterous at times. The former Porsche CFO has more of a quiet personality. "It's basically very simple," he used to say, explaining his version of the VW takeover. It was all about "cash-settled call options" and "cash-settled put options," he would say with a smile.

The two financial instruments were essentially bets between banks and Porsche on the future development of the VW share price. In a simplified way, this is how it worked: Porsche bought call options, which featured a fixed base price for a VW share. If the share went above this price, the banks would have to pay Porsche the difference. In buying the call options, Porsche hedged against rising VW share prices, which could have hampered a takeover.

On the other hand, Porsche sold put options to banks. They also included a fixed base price for a VW share. If the VW share fell below this price, Porsche would have to pay the banks the difference. The deal enabled the banks to hedge against a decline in the VW share price.

Little Risk

From Porsche's standpoint, there was apparently no risk associated with this approach. The risk that the VW share price would fall significantly, so that Porsche would have to pay its wagering partners, the banks, seemed negligible. Porsche continued buying shares after its initial investment in VW in September 2005. The expectation was that the VW share price would continue to rise. And, in fact, it did.

At first Porsche wanted to acquire 20 percent, then more than 30 percent and

finally over 50 percent of VW common stock. The small carmaker was already earning more through market speculation than through the sale of its sports cars.

A statement by the law firm of Freshfields Bruckhaus Deringer reveals the scope of the transactions, which had been kept secret until now. Porsche hired the lawyers to defend it against various plaintiffs who had filed a brief with the Stuttgart State Court, in which they listed Porsche's securities transactions.

When the high-stakes game began in 2005, the amounts involved were still manageable. Porsche initially invested about €510 million in options. But that investment increased in the coming years.

Going Swimmingly

The supervisory board, headed by Wolfgang Porsche, was apparently familiar with the securities transactions. The lawyers' brief reads: "The executive board has informed the supervisory board about the structure, mode of operation, risks and scope of the hedging strategy, as well as about securing the financing of the stock purchases, the VW stock derivative transactions and the liquidity situation."

But no one stopped Wiedeking and Härter. And why should they have? Things seemed to be going swimmingly.

However, the stock transactions eventually became so substantial that, in the view of lawyer Mark Binz, the very existence of Porsche was in jeopardy, which meant that the supervisory board ought to have intervened.

Porsche's law firm, Freshfields Bruckhaus Deringer, writes that, overall, the stock transactions "made a positive contribution to earnings," and that the "associated risks were acceptable."

The fact is that the company paid the outrageous sum of €56.1 billion for share options in the 2008/2009 fiscal year. This is more than the carmaker made from the sale of its sports cars over the previous 10 years. But now the revenues from the options transactions, €53.7 billion, could not offset the gigantic expenditures. The difference came to a before-tax loss of €2.4 billion.

Unforeseen Crisis

The grand plan could still have worked. For that to happen, things simply had to continue as they were going. The banks had to continue financing Porsche's deals and the VW share price could not fall sharply. Crucially, however, the plan did not foresee a financial crisis that would unsettle stock markets around the world.

The rules of the game changed on Sept. 15, 2008, the day of the Lehman Brothers bankruptcy. The share price of virtually every company, including the VW Group, fell in the ensuing weeks. Between Oct. 17 and Oct. 24, VW's share price plummeted from €360 to €209.

The scenario that was never supposed to come about was now reality. And what was supposedly a safe bet had suddenly turned into a deadly risk.

Porsche had sold 60.7 million put options to banks. If the VW share price had fallen below the applicable base value by only €20, Porsche would have had to pay the banks €1.2 billion. A drop of €50 would have brought that amount up to €3 billion.

On Oct. 26, 2008, the Sunday after the drastic fall in the VW share price, Porsche made the surprising announcement that it already owned 42.6 percent of VW common stock and held options for another 31.5 percent. Porsche wanted to acquire more than 75 percent of VW, wrote the board, which had denied this until then.

Accusations of Price Manipulation

The move gave Porsche a few days' worth of breathing room. VW's share price temporarily shot up to €1,000, eventually leveling off at between €200 and €300. Prosecutors believe that Porsche's bank partner, Maple Bank, made sure that the share price remained within that range from then on. The accusation is that Porsche and the banks manipulated the price with their transactions.

This wasn't terribly difficult. Porsche and the banks had access to about 75 percent of VW common stock. The state of Lower Saxony owned 20.1 percent. This meant that only about 5 percent of shares were available for trading. The purchase or sale of a few shares could push the price in one direction or the other.

For example, on May 7, 2009, the VW share price fell sharply at the beginning of the trading day, reaching a low of €222.11 at 9:02 a.m. Then, Maple Bank purchased well over 100,000 shares of VW common stock. The price rose, reaching €229 by 10:45 a.m., a 3 percent increase.

In statements for the prosecution, the German Federal Financial Supervisory Authority (BaFin) has partially exonerated Porsche. Despite these transactions, BaFin argues, there were no violations of Germany's Securities Trading Act. But a key condition supporting this argument is that Porsche still wanted and was able to purchase 75 percent of VW at this time. This is precisely what prosecutors are now calling into question.

Battle of the Expert Witnesses

They are currently having an expert report prepared on whether Porsche was even financially capable of acquiring a three-quarters majority in VW at the time. If it wasn't, this would have meant that the company deliberately deceived shareholders.

Porsche cites an expert report by law professor Joachim Vogel, who found "no substantial proof" that Porsche's behavior "is objectionable under capital market rules or criminal law." Maple Bank insists that it always conducts its business "in accordance with all legal requirements." The attorneys for Wiedeking and Härter were unwilling to comment on the status of the case.

The legal battle in this case is turning into a battle of the expert witnesses. It's already clear that some of the winners of this dispute will be the participating law firms.

Nail-Biting Wait

For Porsche and Wiedeking, it remains a nail-biter. It's a completely new experience for the former CEO -- he is no longer the one calling the shots. Instead, Wiedeking must now wait for others -- the prosecutors in Stuttgart and a judge in the United States -- to reach their decisions.

Wiedeking refuses to believe that he violated any laws. But perhaps he does regret some of the things he said in the excitement of the VW takeover.

At the height of his own stock hype, for example, he crowed: "Many a hedge fund can learn a thing or two from us."

Translated from the German by Christopher Sultan

LOAD-DATE: November 24, 2010